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Economic Outlook

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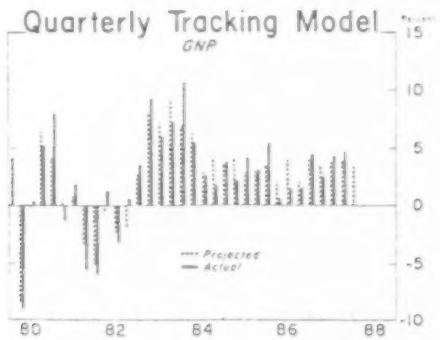
The March employment data confirm that the economy continues to grow moderately in 1988. Employment data are the earliest comprehensive indicators of aggregate economic activity. Our statistical tracking model of quarterly GNP growth is dominated by the effect of growth in the index of aggregate hours worked. This model predicts GNP growth of about 3 1/2% for the first quarter, down quite a bit from the fourth quarter, but far above most economists' predictions, especially earlier in the year (See chart). Because of the huge inventory correction in the first quarter, the employment data may overstate output growth in the first quarter. Adjusting for this inventory effect, our official estimate is for 3% growth, when the Commerce Department announces the number late this month.



The inventory buildup from late last year is just about gone now. Most of the excess was in the motor vehicle sector. In March, motor vehicle industry employment rose for the first time in five months. Producers have raised their production plans for the second quarter and GM is reporting inventories of many models are too low now. Needless to say, sales have exceeded expectations. Light truck sales and production are particularly strong. Production gains in the motor vehicle sector will bolster GNP in the second quarter.

Construction employment has also been surprisingly robust recently. The aggregate hours index in that industry grew at a double-digit annual rate in the first quarter, suggesting recent declines in construction spending are about to be reversed. The pickup in construction activity probably partly reflects strength in business investment. Capacity utilization rates in a number of industries suggest businesses will need to increase new plant expenditures to keep pace with the economic expansion. The backlog of unfilled orders for capital goods has continued to grow rapidly this year, indicating manufacturers are having trouble keeping up with orders in a timely fashion. The March purchasing managers' report showed a rebound in new order growth. The managers also reported a continued slowdown in vendor delivery times. In addition, they noted a trend toward extended lead times for placing orders "reflecting efforts to combat persistent shortages in selected commodities." Machine tool orders are running at about double last year's sluggish pace.

Finally, manufacturing employment growth has dropped off sharply this year. Rather than a sign of weakness, this is probably an indication of the tightened capacity situation. Last year, as export orders rocketed, manufacturers recovered from the sluggish 1984-1986 period, when the high dollar was hurting U.S. industry. As industry recovered last year, employment growth in manufacturing surged. But this is typical in an early recovery phase, when there is plenty of slack capacity. Now, more and more industries are approaching full capacity and additional workers can only be added if new plant and equipment spending brings on new capacity. Since export orders are still strong according to the purchasing managers, 1988 is likely to be a year of strong capital spending and increasing price pressures as businesses pay a premium to get faster deliveries.

Overall the economy is performing admirably. The biggest risk to continued expansion is a financial market crisis. As the consensus view has shifted away from the danger of recession to fears of inflation, interest rates have risen and the Fed appears to have tightened monetary policy slightly. Better-than-expected economic growth raises the possibility that import growth will not slow down as much as the foreign exchange markets would like. This makes the dollar more vulnerable. Because economic growth is turning out to be faster than expected in other countries as well, it is increasingly unlikely that central banks abroad will cut their rates to help the dollar. This raises the chances of higher rates here to support the dollar.

Robert T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual 1987				Forecast 1988				Actual 1986-1987	Forecast 1987-1988	Forecast 1988-1989
	I	II	III	IV	I	II	III	IV			
Consumer Spending	-0.5	1.2	3.5	-1.7	2.0	0.8	0.8	0.8	1.3	1.0	0.5
Business Investment	-1.9	1.3	2.8	0.2	2.0	0.8	0.8	0.6	0.1	1.3	1.0
Residential Investment	-0.4	-0.2	-0.4	0.4	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.2
Change in Inventories*	4.4	-1.6	-1.5	4.9	-2.2	0.4	0.3	0.2	0.4	0.2	0.0
Net Exports	1.8	0.3	-0.6	0.3	0.8	0.9	0.7	0.9	0.3	0.5	0.6
Government Purchases*	1.0	1.5	0.5	0.7	0.5	0.5	0.5	0.5	0.8	0.6	0.4
Real GNP	4.4	2.5	4.3	4.8	3.0	3.3	3.0	2.9	2.9	3.5	2.3

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual 1987				Forecast 1988				Actual 1986-1987	Forecast 1987-1988	Forecast 1988-1989
	I	II	III	IV	I	II	III	IV			
Nominal GNP	8.6	6.3	7.3	7.3	6.4	7.9	8.5	8.7	6.0	7.4	8.5
GNP Deflator	4.2	3.5	2.8	2.7	3.5	4.5	5.3	5.7	3.0	3.8	6.1
Corporate Profits After Tax#	6.7	10.0	9.0	7.6	12.5	10.1	8.5	6.9	8.4	9.5	6.0

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	Jan.	Feb.	Mar.	1987	1988	1989
Consumer Price Index** (%)	0.3	0.2	n.a.	4.4	5.3	6.2
Industrial Production (%)	0.3	0.2	n.a.	3.7	5.1	2.7
Retail Sales (%)	0.0	0.4	n.a.	5.1	5.4	5.2
Auto Sales (million units, a.r.)	10.4	11.0	10.7	10.3	9.8	8.8
Housing Starts (million units, a.r.)	1.37	1.49	n.a.	1.63	1.53	1.35
Unemployment Rate (%)	5.8	5.7	5.6	6.2	5.5	5.5
Merchandise Trade Balance ($ bn., a.r.)	-149.2	n.a.	n.a.	-171.2	-145.0	-110.0

*Adjusted for CCC purchases. **Annual percent changes are December to December. April 7, 1988
#Quarterly data are year-over-year percent changes.
a.r. = annual rate